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Product Liability: The Corporate Response

by Nathan Weber

A Research Report from The Conference Board

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About This Research

Corporate and congressional concern over commercial insurance and tort liability reached an apogee in 1986, with warnings of impending breakdowns in the insurance industry and predictions of dire consequences for business and the economy in general unless serious reforms were enacted. To ascertain the extent, if any, of the crises in both liability insurance and the tort system, especially as they affect corporate decision making, The Conference Board polled the risk managers of 232 major U.S. corporations. The corporations, each having a minimum annual sales revenue of $100 million, represent a range of U.S. manufacturing and nonfinancial service firms. Information provided by the manufacturing managers pertains entirely to *product* liability. In the case of service corporations, the data reflect *professional* liability. Utilities polled reported on general liability. The findings in this report do not deal with such related issues as officers and directors liability, malpractice, or municipal insurance. Nor do they reflect the experience of the nation's small business entities.[1]

Product Liability as a Corporate Function

Primary Responsibility for Product Liability

Title or Dept.	*Percent*
Risk Manager	40%
Chief Counsel	19
CFO	10
More than one	10
CEO	6
Product Safety Manager	4
Marketing	2
Corporate Planning	1
Other	8

Importance of Product Liability

Full time function	20%
Part time function	76%
No response	4%

Respondents, by Industry

Industry	*Number of Firms*
Manufacturing	166
Wholesale & retail trade	21
Transportation & Utilities	18
Services	14
Agriculture, mining	9
Other	5

Type of Manufacturing Firms	*Number*
Machinery and equipment	63
Stone, glass, metal	31
Chemicals, plastics, rubber	20
Food and tobacco	19
Textile	13
Wood products	10
Printing & publishing	10

Respondents' Markets

Soley or primarily consumer market	31%
Soley or primarily industrial and commercial market	47%
Equally consumer and industrial market	17%
No response	4%

[1]For a review of directors liability, see Jeremy Bacon, *Liability Insurance for Directors*, The Conference Board, Perspectives #1, 1986.

Why This Report

The current debate about the crucial issues of product liability and tort reform is a heated one. On one side consumer groups, trial attorneys and others argue that insurance companies have created an insurance "crisis" by underpriced premiums when income from investments was high. Now that interest rates have declined, they say, insurers have been forced to increase premiums at a geometric rate—regardless of actual risk. But insurers blame litigious citizenry, lawyers and judges for an irresponsible use of the judicial system, a use that—in their view—results in astronomical and often undeserved, as well as unpredictable, judgments.

Such risks, insurers say, compel them to raise their prices in simple self-defense. Some corporate risk managers, while acknowledging the insurers' explanations, fault them for placing barriers to the development of alternative insuring mechanisms.

In preparing this report, The Conference Board had two aims: First, to permit the contesting parties to state their cases and to examine the evidence supporting these claims; and second, to ascertain how major corporations (which purchase almost half of the commercial liability coverage) deal with the intertwined issues of insurance availability and product liability.

The risk managers of 232 major U.S. corporations were asked to respond to a detailed questionnaire. Their responses not only shed light on their own corporate experience—from litigation and legal cost experience to product safety improvements—but also raised additional questions about the extent and dimensions of the product liability and insurance availability issues themselves.

JAMES T. Mills
President

Chapter 1
Introduction

Horror stories portraying a judicial system run amuck awarding astronomic amounts to countless individuals wrongly suing large corporations and local governments were a media staple during much of 1986. Many of the stories anecdotally depicted a scenario of rapacious trial attorneys urging consumers to sue manufacturers and other businesses for accidents that occurred largely through the consumers' own carelessness. So enormous was the burden on insurance companies to pay high court awards, the stories maintained, and so unpredictable the whims of overly generous judges and juries, that insurers were forced to increase rates drastically, restrict coverage severely, or eliminate completely their provision of liability insurance—with grave consequences for the very viability of business and governments, and therefore for consumers and the economy in general. The malaise would deepen, the articles maintained, until the tort liability system is radically overhauled.

Predictably, no sooner did the stories circulate, than trial attorneys and consumer activists, sensing the advocacy efforts of the insurance industry, reacted with their own accusations, charging insurers with producing a smokescreen to shield themselves from angry customers. The real cause of the liability-insurance crisis was not the tort system, they argued—which at the least provided consumers with some compensation for injuries and deaths caused by unsafe products and services—but the behavior of the insurance companies themselves. The insurers, they charged, were so ambitious for premium dollars to invest that they undercharged corporate and municipal customers and took on marginally insurable risks when interest rates were soaring in the late 1970's and early 1980's. Once interest rates—and therefore investment returns—fell, the insurers no longer chased after premium dollars to invest. Instead, they multiplied by 100 percent or more the prices they charged corporations and governments for liability insurance. Or they abandoned such coverage altogether for safer, and currently more profitable, policies. All the while the insurers—in an alleged conspiracy, according to some—blamed the injured consumers and their legal protectors. Solve the crisis by reforming the insurance industry, argued the attorneys and consumers, not the tort liability system.[1]

At this writing (November 1986), partisans of each position have spent the better part of the year strenuously promoting their opposing views in the media, at innumerable public forums, and in state and federal legislatures. Efforts on both sides have met with some success, to date mostly at the state level. Reforms of both the tort system and the insurance industry have been enacted, to one degree or another, by over 40 state legislatures, although many of the changes are themselves facing legal challenges. (See page 18 for a summary of state reforms.) Even at the federal level, while temporarily sidetracked, reforms appear more likely to be enacted than at any time during the previous decade, according to many Congress watchers.

Notwithstanding the reforms, the accusations and countercharges show little sign of abating. As the controversy swirls, one fundamental set of questions remains unanswered: What, in fact, has been the impact of the liability and/or insurance crisis on the nation's major corporations and, by extension, on the economy? Further, to what extent has product liability insurance truly become unaffordable or unavailable to large U.S. corporations, and how has management responded to this development? How in fact has the corporate world reacted to both current insurance prices and to lawsuits filed by aggrieved consumers?

Some answers to these questions are provided in this report. The information was supplied by risk managers of

[1] A brief sampling of such articles includes: "Sorry, America, Your Insurance Has Been Cancelled," *Time*, March 24, 1986; "Business Struggling to Adapt As Insurance Crisis Spreads," *Wall Street Journal*, January 21, 1986; "Mass Torts: A National Disaster," *Best's Review*, December 1985; "Liability: Business Dives for Cover," *International Business Week*, February 10, 1986; "Liability Insurance: A Growing Crisis," *New York Times*, February 20, 1986; "Drive to Limit Liability Awards Grows as Consumer Groups Object," *New York Times*, March 2, 1986; "Finger Pointing Distinguishes Attempts to Fix Blame for Liability Crisis," *National Journal*, March 15, 1986; "When Products Turn into Liabilities," *Fortune*, March 3, 1986; "Products Liability: Boon or Bane?," *Road Rider*, April 1986; "The Tort Reform Quagmire," *Forbes*, August 11, 1986.

232 major U.S. manufacturing, trade and service corporations, excluding financial firms, who responded to a detailed questionnaire. The firms record a minimum of $100 million a year in sales.

Major Finding: Minor Impact

The most striking finding is that the impact of the liability issue seems far more related to rhetoric than to reality. Given all the media coverage and heated accusations, the so-called twin crises in product liability and insurance availability have left a relatively minor dent on the economics and organization of individual large firms, or on big business as a whole. In the words of one manager: "There may be less here than meets the eye."

Product liability: For the major corporations surveyed, the pressures of product liability have hardly affected larger economic issues, such as revenues, market share, or employee retention. Liability lawsuits, which are indeed numerous, are overwhelmingly settled out of court, and usually for sums that are considered modest by corporate standards. As a management function, product liability remains a part-time responsibility in most of the responding firms. Where product liability has had a notable impact—where it has most significantly affected management decision making—has been in the quality of the products themselves. Managers say products have become safer, manufacturing procedures have been improved, and labels and use instructions have become more explicit.[2]

Insurance availability: For most of the companies surveyed, product liability insurance coverage has remained fairly steady, notwithstanding increases in its cost. Furthermore, the source of the insurance has remained constant: Corporations continue to secure liability insurance primarily from standard commercial insurers, as opposed to "captives" or other source alternatives. (However, a growing number of firms say they either have alternative sources, or will consider alternatives for the near future.) While management has passed along the increased cost of insurance to consumers in the form of higher prices for products and services, the extent of such price rises has been minor.

[2]For a description of the safety program undertaken by Johnson & Johnson in the Tylenol case, see David E. Collins, "Cultural Heritage and Crisis Management," in Melissa A. Berman (ed.), *Corporate Culture and Change*, The Conference Board Report No. 888, 1986. For a broader analysis of product safety, see E. Patrick McGuire, *The Product-Safety Function: Organization and Management*, The Conference Board Report No. 754, 1979; and E. Patrick McGuire, *Managing Product Recall*, The Conference Board Report No. 632, 1974.

Structure of Insurance Policies

Although most product-liability insurance policies are structured in a similar fashion—with a deductible layer, a primary layer, and an excess layer—some are different enough to render exact comparisons difficult. For example, some policies, defined as "Paid Loss Retro," actually require the insured corporation to pay back the insurance company for the entire amount of all claims. Because the payback can take several years, this type of policy is beneficial to a corporation's cash flow. Such policies may be viewed either as regular insurance, since a commercial insurer initially pays the claim, or as delayed self-insurance. For the purposes of this report, "paid loss retro" policies are viewed as regular, commercially provided insurance.

A careful reading of the insurance press—which, understandably, has taken the lead in trumpeting the crisis—reveals that doubts about the extent or severity of the liability situation had been voiced on different occasions by experts. In May, for instance, a corporate risk manager, speaking at the 50th annual Chicago Insurance Day, announced: "We really don't see this as a crisis. It's just another manageable problem." In June, an advisory committee of the National Association of Insurance Commissioners (NAIC), consisting of representatives of several insurance trade associations, issued a report asserting that the crisis is not anywhere as widespread as generally believed, even for such "high risk" entities as liquor stores, daycare centers and municipalities. (That report was immediately tabled by NAIC, which had not been shown the results prior to its release to the press.[3]) And in the area of tort law, a new study of 172 federal cases and 119 state cases—dealing primarily with product liability—found that the awarding of punitive damages was, for the most part, "insignificant." That study was published in a journal of the American Enterprise Institute.[4]

The findings of the present survey also refute the general contention of a severe and deepening crisis in tort liability and insurance availability, at least for the nation's large corporations. The impact on the general economy, likewise, is believed to have been minor.

[3]Coleen Mulcahy, "Liability Woes Not at 'Crisis' Level, RM Says," *National Underwriter*, May 29, 1986; Lisa S. Howard, "NAIC Tables Report Stating Ins. Crisis is Exaggerated," *National Underwriter*, June 20, 1986.

[4]William M. Landes and Richard A. Posner, "New Light on Punitive Damages," *Regulation*, September/October 1986, p.33 ff.

Chapter 2
Insurance Issues

Amount of Coverage Remains Steady

In spite of legitimate complaints about the rising cost of product and professional liability insurance, the amount of coverage purchased by corporations has remained remarkably constant—and in many cases has actually increased—over the past five years. In 1982, when the insurance market was "soft"—a buyer's market in which premium prices were low and supply or availability (called "capacity" in the insurance industry) was plentiful—52 percent of the firms surveyed were insured for $1 million in primary coverage. By 1986, faced with a "hard" market in which the insurance seller was in command with high prices and restricted supply, 54 percent of those same firms had the same amount of primary liability coverage. The percent of respondents who had no coverage grew by only three points between 1982 and 1986, from 7 percent to 10 percent.

The only place coverage declined was at the low end of the scale: A fifth of the firms had coverage *under* $1 million five years ago, whereas today almost none (4 percent) of the firms insures for that amount. This probably reflects the standardization of a $1 million primary coverage contract within the insurance industry.

Coverage in all other ranges has remained stable regardless of the amount of insurance held. For example, 9 percent of the firms were covered for $5—$10 million in 1982, and 8 percent in 1986. (See Table 1.)

These findings confirm the results of earlier research conducted by the Risk and Insurance Management Society (RIMS), a professional organization whose members are, primarily, corporate risk managers. In a survey of year-end insurance renewals released in February 1986, RIMS reported

Table 1: Product (or Professional) Liability Insurance (232 Corporations)[a]

Primary Coverage	1986	1985	1984	1983	1982
Below $1 million	4%	13%	18%	19%	20%
$1 million	54	56	53	52	52
$1.1—$2 million	16	7	7	6	5
$2.1—$4 million	4	2	2	2	1
$5—$10 million	9	8	8	8	8
$11 million and above	4	7	7	6	6
No coverage	10	7	7	7	7
Excess Coverage					
Below $25 million	41%	20%	19%	22%	25%
$25-$49.9 million	26	18	16	17	17
$50-$99.9 million	17	27	26	24	26
$100 million or above	11	29	33	31	26
No coverage	6	4	4	4	5

Primary product liability coverage has remained remarkably constant between 1982 and 1986. However, the amount of excess liability coverage has declined. In 1982, 26 percent carried excess coverage of $100 million or more. By 1986, only 11 percent had that amount. The major change occurred between 1985 and 1986. Excess coverage is provided by reinsurers, many of whom abandoned the market in 1985.

[a]Details may not add to 100% because of rounding.

Table 2: Premium Payments for Primary Coverage (232 Corporations)[a]

	1986	1985	1984	1983	1982
Below $25,000	7%	11%	15%	16%	16%
$25—$49,999	4	8	11	12	12
$50—$99,999	8	15	16	17	16
$100—$499,999	32	32	31	26	27
$500,000 and above	36	26	18	18	17
No response	13	9	9	11	12

Corporations able to secure liability insurance with premium payments below $25,000 dropped by over half from 1982 to 1986. During the same period, those having to pay $500,000 and above more than doubled.

[a]Details may not add to 100% because of rounding.

that for product liability insurance, "limits [i.e., extent of coverage] and deductibles were stable" for 237 respondents.[5]

Declines in Excess Coverage

Where there is a noticeable difference between 1982 and 1986 is in the area of excess, or surplus, coverage. Excess coverage, with limits well above those of primary coverage, is made available for additional premium payments, and is fairly standard in most commercial liability-insurance policies. In 1982, a quarter of the firms purchased excess or surplus coverage of $100 million or more; at present, only a tenth of the companies could obtain, or were willing to buy, that much. Instead, far more companies have had to accept a much lower amount of excess coverage—usually under $25 million. Today, 41 percent of the firms have that relatively small amount, whereas five years ago only a quarter of the companies had to settle for such low excess coverage.

The explanation for this is that excess coverage is provided mainly by reinsurers—often referred to as "the insurer's insurer." Reinsurers had left the market in droves by 1985, particularly in liability lines. According to the Insurance Services Office, the industry's ratemaking advisory body, since 1984, 90 reinsurers withdrew totally or partially from the U.S. market.[6]

By mid-September 1986, however, the reinsurance industry showed signs of recovery. According to congressional testimony prepared by the Reinsurance Association of America (RAA), first quarter premiums and surplus (net worth) were up, and new reinsurance companies were entering the market. However, this improving position does not mean that reinsurance will now be more available or less costly. "Reinsurers will commit their resources only where they believe the potential for profits is greatest," a spokesperson for the RAA said. "Therefore, they cannot say that there will be increased capacity in certain lines, pollution coverage in particular."[7]

How Insurance is Obtained

Here again, patterns are remarkably steady, notwithstanding a five-year-old federal law that makes it easier to secure insurance from alternative sources. (See discussion of the Product Liability Risk Retention Act, page 20.) For primary coverage, corporations chose—by an overwhelming amount: 89 percent in 1982, 86 percent today—to buy their insurance from regular commercial insurance providers, as opposed to, say, industry captives or other arrangements. "Single parent captives," or insurance companies set up by a corporation simply to insure itself, provided coverage for only 6 percent of the firms five years ago, and only 5 percent of the firms today. This pattern is almost identical for excess coverage.

Increased Cost of Insurance

The most significant change for corporations since 1982 has been the cost of the premiums. The Board survey reveals that management complaints about the increasing cost of liability insurance premiums are based on fact. In 1982, more than one in four companies paid under $50,000 in premiums for primary coverage. By 1986, only one in ten firms paid that relatively low amount. At the high end of the premium price scale, five years ago only one out of seven corporations spent $500,000 or more on primary premiums. Today, over twice as many—more than one out of three—companies have to spend that much to obtain the same amount of coverage. Even in the middle ranges, the findings reveal that corporations are spending more. Premium costs of between $50,000 and $100,000 were paid by 16 percent of the firms in 1982. Today, only half as many can pay that middle range price. (See Table 2.)

[5]"Insurance Availability Study: Management Report," New York: Risk and Insurance Management Society, Inc., 1986, p.II-2.

[6]Daniel J. McNamara, "Remarks at the Annual Meeting of Insurance Services Office, Inc.," New York: January 14, 1986.

[7]"Reinsurance Industry Resuming Profitability, House Panel Told," *Daily Executive Report*, September 11 1986, p. A-18.

The Insurance Cycle

The theory that current price rises in the cost of commercial liability coverage are due, at least in part, to the built-in cyclical nature of the insurance industry has adherents both within the industry itself and among its critics. Essentially, the theory holds that the industry's underwriting income—the money it takes in through the sale of premiums—as well as the prices it charges for those premiums, move up and down in a fairly regular pattern. The most commonly cited time period for a cycle is six years, although the last downward movement alone lasted six years, from 1978 to 1984, which means the current cycle could have a duration of at least 12 years.

What causes the cycle? While there is no absolute answer, one actuary at the Insurance Services Office listed the elements that seem to influence most cycles: competition, capacity to cover losses, regulation, loss projection techniques, and "exogenous" or outside factors, such as interest rates and increased litigation in society.

How these elements interact to generate a "typical" cycle may be described as follows:

Upswing: The existence of a highly competitive industry, with some 3500 property-casualty insurance companies vying for the premium dollar, suggests that there is a great deal of "effective demand," or demand backed up by the ability to pay. Insurers, therefore, feel that they can set premium prices high, increase deductibles, and tighten the limits of the coverage itself. This is the upswing period of a cycle: income and prices are up, and moving higher.

If interest rates are also high, the insurers are doubly fortunate: they receive high premium prices (or underwriting income), and high returns on their investments. The upswing continues. The market is defined as "hard," or a seller's market.

At some point, insurance consumers, especially corporate consumers who pay 47 percent of total premiums, start to become dissatisfied. They feel they are paying too much for too little coverage. They begin to shop for other insurance companies, or to seek insurance from alternative mechanisms made possible by legislation. Thus they may establish a "captive" (their own insurance company), purchase coverage from an industrywide captive, or actually consider "going bare"—doing without insurance altogether. In any event, effective demand starts to decline.

Because interest rates are high, insurers continue to seek the premium dollars to invest. Faced now with the start of a decline in demand, they stop raising prices. The cycle has peaked: Prices are steady, and underwriting income no longer rises.

Downturn: Demand continues to decrease. Interest rates, however, are soaring. Any insurer that does not take in premium dollars will have that much less to invest, and will fare poorly in a fiercely competitive industry. Thus insurers begin to lower their rates and offer increased coverage. The downswing of the cycle is now on, and the insurance market is defined as "soft," or a buyer's market. Prices get lower, deductibles are reduced, and limits (coverage) are broadened. Some demand may return.

Liability claims against the insured corporations may increase, as consumers and trial lawyers look to litigation to obtain compensation for injuries suffered while using various products. The insurance companies are obliged to pay those claims. But because the litigation process is a slow one, payment is not made immediately. The longer the insurer holds onto the money, of course, the more interest it earns.

Eventually, however, the claims are paid. In fact, because premiums are so low, more money may go out in claims than is covered by the premium income. The longer prices and underwriting income stay low, the more precarious the fortunes of individual insurers. Some insurers, in fact, go out of business. The increasing failure rate sends warning signals throughout the industry.

Upswing: Eventually, perhaps suddenly, interest rates start to decline, which means that investment income no longer compensates for the lack of sufficient underwriting income—at least, according to insurers.[1] Faced with low investment income, low operating income, a decrease in the number of competitors, and a projection of high losses, the remaining insurers decide to curtail their low prices/high limits policies. The cycle has reached bottom. Premium prices start to go up, limits are reduced, or policies cancelled altogether in favor of "safer" risks. The upswing has begun.

[1]Figures released by the insurance industry to substantiate the argument that investment income is too low to sustain claims payment, and therefore premium prices must rise, are often at odds with data released by consumer critics and government agencies. For example, The Insurance Services Office, an industry-established rate setting body, maintains that the drop in investment income in 1984 resulted in a $4 billion operating *loss* for the industry, which would continue into 1985. But the U. S. General Accounting Office argues that the industry's investment income provided a net *gain* of $75 billion from 1975 through 1984. And the National Insurance Consumer Organization argues that the industry had a total profit in 1985 alone of $7.4 billion. For the industry's position, see *Insurer Profitability: The Facts*, New York: Insurance Services Office, February 1986, esp. p.13. For the GAO's position, see *Information on How the Property/Casualty Insurance Industry is Taxed*, Washington, D.C.: U.S. General Accounting Office, Report – GGD-86-16FS, October 1985, Chart 2. For the consumers' position, see Robert Hunter, *And Now the Real Facts*, Arlington, Va: National Insurance Consumer Organization, 1986, page 5.

Table 3: Premium Payments for Excess Coverage (232 Respondents)[a]

	1986	1985	1984	1983	1982
Below $25,000	3%	10%	17%	20%	20%
$25—$49,999	6	9	17	18	18
$50—$99,999	5	15	22	21	18
$100—$499,999	23	34	23	21	22
$500,000 and above	48	20	9	9	8
No response	15	11	11	12	14

Premium payments for excess liability coverage have gone up for most corporations. In 1982, a fifth of the respondents paid under $25,000 in excess premiums. By 1986, only 3% could obtain excess insurance at that rate. At the high end, almost six times as many corporations must pay half a million dollars or more for excess coverage today, compared to five years ago.

[a]Details may not add to 100% because of rounding.

Premium payments for excess coverage reveal even more starkly the rise in prices. For example, in 1982, one out of five corporations paid under $25,000 in excess coverage premiums. Today, very few firms—only 3 percent—pay that low amount. At the high end of the scale, the number of firms having to pay a half million dollars or above for excess coverage soared from 8 percent to 48 percent. (See Table 3.)

The increase in premium costs is borne out by the RIMS survey mentioned above. Of the respondents in that survey, more than a third reported that they had to pay premium increases of over 100 percent in order to renew their product-liability policies.

Deductibles Have Risen

Another measure of insurance cost is the steepness of the "deductible" portion of a policy. The deductible is the amount of a claim that must be paid by the customer before the insurance company begins to pay. In effect, the higher the deductible, the costlier the insurance policy.

For respondents in the survey, deductibles have risen, but not drastically. One in seven of the companies paid no deductible either in 1982 or 1986.

At the low end of the scale, five years ago a little over a third of the firms' policies had deductibles of under $100,000, whereas today only a quarter of the companies are liable for that amount.

Corporations having to pay between $100,000 and $499,999 increased by only five percent points during the past five years.

At the high end of the scale, the number of firms having to pay deductibles of $1 million and above doubled between 1982 and 1986, from 9 percent to 19 percent. (See Table 4.)

Overall, then, the survey findings on deductibles reinforce the RIMS study, which concluded that deductibles for product liability insurance were stable at their latest renewal.

To be sure, those firms that do have to bear the increases are finding it expensive. In some instances, the Board survey shows, the rise has been huge: A producer of industrial chemicals in Mississippi saw its deductible increase 20-fold in the past year, from $5,000 to $100,000, while its coverage dropped from $5 million to $1 million. Nor can it be said that the industry of that firm—chemicals—is the sole cause of the increase. A manufacturer of diesel engines in Indiana had its deductible leap from under $100,000 annually for the previous four years to $1 million in 1986, while the amount of its coverage has remained constant, as it has for most of the firms. A West Coast computer manufacturer went from no deductible in 1984 to $25,000 the following year to $100,000 in 1986—all for the same $1 million in coverage. And a Texas manufacturer of oil field equipment and related services had its 1986 deductibles increase from $100,000 to $250,000 over

Table 4: Deductible Retention (232 Corporations)[a]

	1986	1985	1984	1983	1982
No deductible	16%	15%	16%	15%	15%
Below $100,000	26	32	34	35	38
$100,000—$499,999	27	34	35	33	32
$500,000—$999,999	12	8	6	7	6
$1 million and above	19	11	9	9	9

Deductibles, which effectively add to the cost of insurance, have risen, but not drastically for most. Between 1982 and 1986, the number of corporations paying deductibles under $100,000 decreased from a little over a third to a quarter. By contrast, the percent of corporations having to pay $1 million or above doubled between 1982 and 1986.

[a]Details may not add to 100% because of rounding.

the previous year, with a sizable increase in its premium cost, for the same $1 million coverage.

Increases in deductibles, plus rising premium costs, are motivating about a quarter of the respondents to consider switching to an alternative insurance supplier within the next two years. The alternative insurer will likely be some form of captive company, established either by the firm itself, or by several allied firms in a joint venture. One example: Eight corporate risk managers recently announced plans to establish the Corporate America's Risk Exchange (CARE). The new agency would provide up to $50 million in excess coverage, with deductibles as low as $1 million.[8]

[8]David Katz, "Risk Managers Plan Their Own Excess Insurer," *National Underwriter*, September 26, 1986.

A Risk Manager's Dream?

Not every risk manager is grumbling about the insurance industry these days. The treasurer of a metal foundry in Milwaukee had requested a higher deductible this year, because he wanted an increase in liability coverage. But the insurance company, instead, *lowered* the deductible—from $25,000 to $5,000—while continuing to provide the same million-dollar coverage. The reason? "This may sound strange," reported the treasurer, "but they said that when they stipulate higher deductibles, they lose in premium payments. Also, that in the event of a lawsuit, the more we have to pay in deductibles, the more control we have over the terms of payment. They didn't want to give up that control."

Chapter 3
Legal Issues

Soaring Number of Lawsuits

The current findings leave no doubt that a substantial number of lawsuits are filed against companies on product liability charges. Two-thirds of the corporations surveyed have had such suits filed against them within the past five years. While the number of suits varies from one to 1,000 or more per year, most of the companies are defendants in multiple suits. Thus, among those sued, 60 percent face up to 25 lawsuits annually, 20 percent must deal with between 30 and 100 suits each year, and 14 percent are defendants in 101 to 500 suits.

Causes and Effects of the Lawsuit Increase

Consumer groups and trial attorneys maintain that the rising number of lawsuits is a consequence of unsafe products or unclear instructions on using products—or simply growth in the number of product users.[9] Corporate spokespeople reject that argument. They maintain that they are named in so many suits not because they are primarily responsible for injurious use of their products, but because of a shotgun legal tactic favored by plaintiffs' attorneys. This shotgun approach—naming as many defendants in a lawsuit as possible—is facilitated, they insist, by a legal doctrine known as "joint and several liability."

Essentially, the doctrine of joint and several liability holds that all the defendants found culpable in an action are equally—and fully—liable to compensate the plaintiff for damage suffered. If any one of those defendants cannot pay

[9]Robert T. Roper, "A Preliminary Examination of Available Civil and Criminal Trend Data in State Trial Courts for 1978, 1981, and 1984," Williamsburg, Va: National Center for State Courts, April 1986.

Litigation Explosion: Fact or Myth?

Few issues in the debate over tort reform and liability insurance have generated as much disagreement, buttressed by mountains of statistics, as the so-called litigation explosion. Insurers and corporate risk managers tend to argue that the explosion is real, and is a major—if not the primary—cause of the crisis in insurance cost and availability. Trial attorneys and consumer advocates maintain the explosion is a myth, and that any increase in litigation is merely a reflection of an increase in population, that is, of the increasing number of consumers using products. Following are excerpts from position statements issued by contending parties.

Insurance Information Institute: "Since 1974, the number of product liability lawsuits filed in U.S. District Courts has increased more than eight-fold, from 1,600 to over 13,500—a growth rate of 22 percent a year." "Of 10,745 cases filed [in federal district courts] in 1984, about 90 percent involved personal injuries. . . .The number of product liability filings was 16.5 percent higher than that recorded in the preceding fiscal year."

Insurer Profitability: The Facts, p.27, and *1985-1986 Property/Casualty Fact Book*, p.52.

National Center for State Courts: "For the entire period 1978-84 total tort filings increased 9%; however, the population also increased by 8%. . . .The often cited litigation explosion thus appears to be exaggerated with respect to the total number of civil filings. . .The source of the perception that there is a litigation explosion may be founded in a changing mix of civil cases, increased complexity of the cases being filed, and widespread media reports of enormous awards in relatively few cases."

A Preliminary Examination of Available Civil and Criminal Trend Data in State Trial Courts for 1978, 1981, and 1984, p.2.

the amount a court awards, the other defendants must make up the difference, regardless of how small a role they may have played in the actual injury. Ultimately, the defendant most able to pay—the defendant with the "deepest pockets," usually a large corporation or a municipality—may be called upon to pay the entire amount. One of the theories behind this doctrine is that compensation for the person suffering a serious or incapacitating accident takes priority, as a matter of justice, over allocating damages according to the degree of a defendant's responsibility. Were it not for the doctrine, say its advocates, injured people who may be effectively unable to earn a living, or maintain a normal life, would have a much more difficult time obtaining compensation for their injuries.

Regardless of the merits or defects of the doctrine, facing multiple suits each year may be a daunting task. And indeed it is, for an individual or even a small business, no matter what the number of suits. Time spent in court, as well as pretrial depositions and responses to interrogatories, can detract seriously, if not completely, from the time needed to conduct a business.

But for many major corporations, the task of responding to a large number of lawsuits has become a way of business life. For them, defending against legal allegations has become a matter of course, an everyday business expense. The time and money needed to deal with each and every suit, while certainly steep, are not life threatening in most cases. For a few, of course, such as Johns Manville and A. H. Robins, the weight of such litigation has led them to seek refuge in bankruptcy. But the impact on most of the corporations studied has not been that serious.

The risk manager of a food and chemical products

Court Studies, Inc.: Commenting on the National Center for State Courts study: "Civil case loads are very sensitive to economic conditions in prior years, mainly two years earlier. . . .A 1-percent increase (or decrease) in the economy leads to a 1-percent to 2-percent increase (or decrease) in civil case loads two years later. The recession in 1981-82, therefore, caused case-load growth to halt in 1982, 1983 and 1984. By mid-1983 the economy began growing rapidly; so case loads rose substantially in 1985. We can expect a very large increase in 1986. . . .During 1973-83, civil filings in general jurisdiction trial courts grew by 43 percent in the 33 states with statistics, even though many cases went to lower courts when states raised jurisdiction amounts. Trial case loads in federal and state courts have been increasing that fast, and probably faster, after they dropped during the depression and World War II."

Thomas B. Marvell, "There *Is* a Litigation Explosion," *National Law Journal*, May 19, 1986.

American Bar Foundation: "There is a certain allure to large numbers, they just seem important. By themselves, however, they are meaningless without some standard by which to judge their meaning. For instance, [one author] claims there were over 360 awards of $1 million or more in 1984. But what makes 360, or even 401 as *U.S. News and World Report* claims, too high a number or an insignificant number? In the same set of remarks as the 360 figure, [the author] uses a figure of 13 million private law suits filed in 1984. Using this figure, those 360 $1 million awards represent 0.003% (3/1,000's of one percent) of the 13 million filings."

Stephen Daniels, *Punitive Damages: Storm on the Horizon?*, February 1986, p.6.

manufacturer in Ohio was asked how the 250 lawsuits his firm has faced within the past five years have affected the company's ability to do business. "Not at all," he replied, adding: "It doesn't take much to set up a claims handling operation, even if you don't have insurance." He said that he believes this to be the situation in many major corporations. An exception, he added, might be firms that manufacture a product that has had widespread catastrophic consequences.

The risk manager of an energy company in the Midwest also replied "No" to the question of whether facing 1000 lawsuits adversely affected the company's ability to do business during the past five years. "It's relative to the size of the company," he said. "Obviously, it would bury us if we were a small Ma and Pa operation. But we are a *Fortune* 25 company."

And a manager of a major retailer in the Southwest said that the problem was not in the lawsuits lodged against his firm, but in the fact that some of the medium-sized vendors or manufacturers could not afford product-liability insurance. He said his firm would not sell any product that was not covered by such insurance. To do so in the light of joint and several liability, he continued, would subject his company to paying the full amount of claims for which they were barely responsible.

Thus, the sheer number of suits a corporation faces may not have a significant bearing on its ability to carry on its regular business operations. The impact of the liability lawsuit phenomenon on management decision making may vary greatly among firms in general, but appears to be relatively minor for those surveyed. This conclusion is suggested by two survey findings: Product liability remains a part-time function in most corporations, and most of the cases are settled out of court.

There is no question that, even where corporations are not required to make significant court-awarded payments, they must still bear the ever increasing cost of attorneys and associated fees. (The cost to the public may also be high. A recent study of the cost of litigation to taxpayers—the cost to government, or society in general—estimates that administrative expense, independent of awards, will reach between $16 and $28 billion a year by decade's end.[10]) For this reason, the elimination of joint and several liability—especially in the awarding of punitive damages (as opposed to awards for economic loss, such as wages or medical expense, or for pain and suffering)—is a major priority of corporations active in efforts to reform tort law. See section on "Reforms Sought by Corporations," page 15.

Chart 1

Resolutions of Latest Five Liability Lawsuits

(659 Cases)

*It is presumed that the two thirds of the cases resulting in out-of-court settlements involved payments by the defendant firms to liability plaintiffs.

Court Verdicts: How Corporate Defendants Fare

Corporate and insurance industry spokespeople argue that courts are granting plaintiffs too many awards—and at too high a dollar amount. To explore this issue, this survey asked respondents to indicate which way the judgment went for the latest five cases in which they were defendants. For all the complaints about judges and juries being overly sympathetic to consumers who bring suits, the defendant corporations in the survey did not fare badly in the courts. Out of a total of 659 most current cases, only 6 percent of the final court judgments were against the firms after all appeals were exhausted.

In a quarter of the suits, the cases were either dismissed, or the court ruled in favor of the firm. For the remaining two-thirds, the cases were settled out of court—presumably with the firms' insurers offering plaintiffs a settlement. (See Chart 1.)

The Cost of Claims Settlement

The Board's survey shows that for the majority of firms, the out-of-court settlements in liability cases tends to payments of less than $25,000. For over two thirds of the cases reported, the settlement amount was under $50,000. However, the actual costs to a firm may be considerably higher. The total expense must include salaries and overhead for staff attorneys who worked on the cases; considerable staff time in depositions and interrogatories demanded by the claimant's attorney; and the retainer fee of law firms that customarily act as counsel for the corporation—particularly if the case is filed in any out-of-state jurisdiction.

[10] Andrew Schotter and Janusz Ordover, *The Costs of the Tort System*, New York: New York University's C.V. Starr Center for Applied Economics, March 1986.

Table 5: Out-of-Court Settlements of Five Latest Cases (403 Cases)[a]

	Case 1	Case 2	Case 3	Case 4	Case 5	Average
Below $25,000	51%	55%	55%	60%	62%	57%
$25—$49,999	16	14	12	13	9	13
$50—$99,999	10	11	16	17	14	14
$100—$499,999	15	14	12	7	10	12
$500—$999,999	2	3	3	1	3	2
$1 million and above	6	3	1	1	3	3
Total cases:	96	88	83	70	71	403

[a]Details may not add to 100% because of rounding.

Out-of-Court Settlements

How high are the out-of-court settlements on average? For the 403 out-of-court settlements for which information was provided, actual financial awards were for amounts below $25,000—a minor sum by corporate standards. This was so in more than 57 percent of the cases. At the high end of the scale, a little over 2 percent of the settlements were for $500,000 or above. Million dollar-plus settlements were awarded only 3 percent of the time. (See Table 5.)

Court Awards

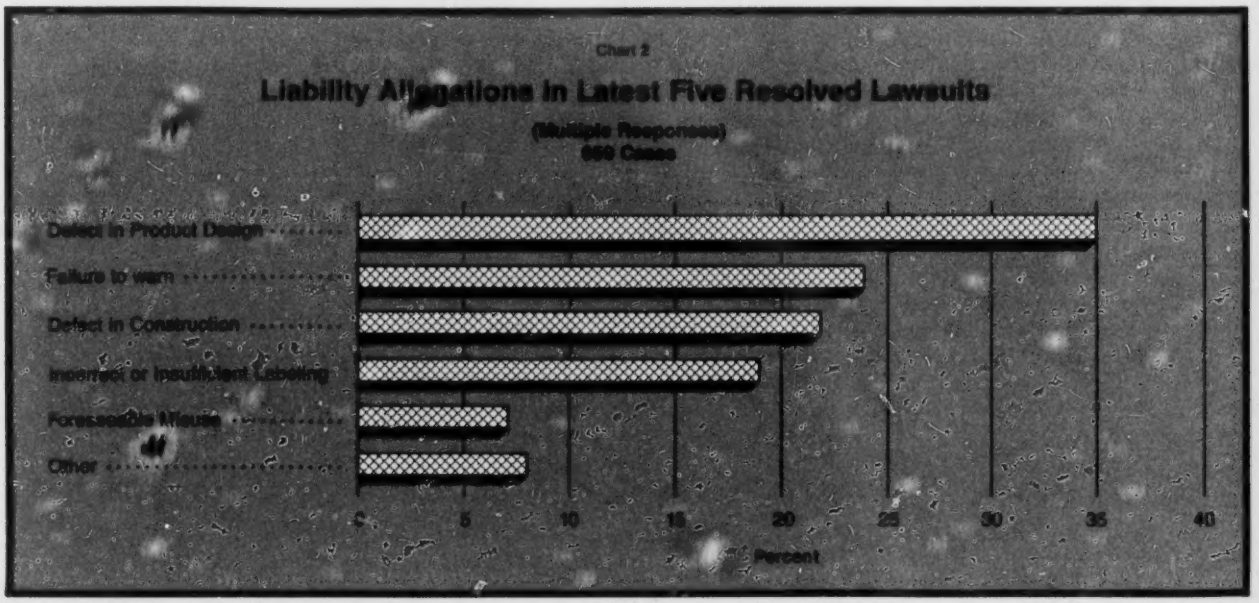
Very few of the risk managers responded to questions seeking information on the size of awards granted to plaintiffs by the courts. This is understandable in light of the finding that only 6 percent of the court judgments were in favor of the plaintiffs. Nevertheless, of those who did respond, most of the awards for economic loss, pain and suffering, and punitive damages were for amounts under $25,000.

Most Common Allegations

Allegations brought in liability actions range from flaws in the design and construction of products to poor or misleading use instructions, to misrepresentation about the product's features in promotional literature, such as advertisements. (See Chart 2.) For the corporations surveyed, the most frequent allegations were as follows:

Defect in product design: The most common allegation, according to the survey, is that the design of the product in question is defective. In effect, people who suffer accidents or injury through the use of a product most commonly charge that the mishap was a consequence of the faulty design of the product. This was the allegation in over a third of the latest 659 cases brought against respondents.

Failure to warn: In almost a quarter of the cases, companies are sued on an alleged failure to warn the consumer adequately about potential—forseeable—hazards associated



with use of a product. Examples include drinking or inhaling chemical products, standing on the top step of a ladder, or the use of a chain saw without first clearing away potential obstructions. In a small number of cases, manufacturers are sued on the grounds that they did not foresee a "reasonable" misuse of a product—such as using a screwdriver as a lever, or a hammer to bang objects other than nails—and so did not provide proper warning.

Insufficient or improper labeling: Related to a failure to warn is insufficient or incorrect labeling of a product, which plaintiffs allege can cause or contribute to a misuse. A fifth of the cases in the survey included this allegation.

Construction defect: Another fifth of the cases alleged a defect in the construction of a product, as opposed to the actual design. In such cases plaintiffs are charging a lapse in the manufacturer's quality control procedures.

Chapter 4

Management Decision Making in Response to Liability

The primary intent of The Board's research was to weigh the impact that product liability has on management decision making, and, by extension, on the economy in general.

Price increases: The most common decision made by management in light of the product-liability issue has been to raise the cost of products and services. This decision was cited by over two-fifths (43 percent) of the respondents. No other management action was undertaken by as many corporations.

The extent of the increase, however, has been small. In most firms, liability expense consists of three or four major components: the cost of insurance, litigation fees, settlement amounts, and, sometimes, overhead. Only the first component—insurance—can be measured with any degree of accuracy. Therefore, respondents were asked how much of the final prices of their products can be attributed to the cost of liability insurance. For two-thirds of the firms, the answer was *one percent or less*. For another 11 percent of the companies, liability insurance accounted for only 2 to 3 percent of the final price.

This is the case even for many firms with high liability potential. For example, the risk manager of a corporation that manufactures aircraft parts and other engineered materials explained: "We sell $150 million a year in aircraft products, and we pay $250,000 in liability premiums. It is a very small amount." Another corporation, a California aerospace manufacturing firm, also indicated its pass-along in prices added only 2 to 3 percent to its price list. (Some firms in the sporting goods industry may be an exception to this rule. See box on this page.)

It is almost impossible, for several reasons, to obtain data on the other components—in particular, litigation expenses and judgments or settlements. First, corporations, particularly publicly held firms, are loath to reveal how much they pay in litigation costs. They are even hesitant to share such information with their own trade associations, according to officials of those groups. Second, the litigation expenses vary with the number of suits, with the states in which they are sued, and with the amount of time it takes to settle each case. Thus, unlike insurance, litigation expenses are not known at the start of any one year, and cannot easily be computed into the final price of a product. (This is also true, of course, for settlement amounts.) Efforts to obtain data on the portion of prices attributable to litigation expenses in such industries as housewares and appliances, machine tools, and automobiles were not fruitful.

In the processed food industry, however, a trade association official offered a "ballpark estimate" for the price pass-along: "Combining the expense of insurance premiums, legal fees, staff time, plus a huge amount of laboratory work, between 6 and 10 percent of the final price reflects these expenses." He added, however, that the amount of the price increase is very small in absolute figures. "Because of the extraordinary high quality control that exists in the processed food industry, our settlement costs are very low compared

Product Liability and Consumer Prices in the Sporting Goods Industry

While it is difficult to ascertain how much of the cost associated with product liability—insurance, litigation expense, settlements—is reflected in the final price of a product, the pass-along may be high among some sporting goods manufacturers. A survey of its members undertaken by the Sporting Goods Manufacturers Association in 1980 revealed that, among a small sample of firms, products with a $45 wholesale price have $11 that can be attributed to insurance and litigation costs.

Another type of cost to the consumer may be hidden. "If a distributer can't get insurance, or if he has to pay too much in litigation costs, he goes out of business," said a spokesperson for the National Sporting Goods Association, a retailers' trade group. "Industry becomes less competitive, so you have fewer choices. For example, today there are only two manufacturers of football helmets. The less competition, the higher the prices."

to most other industries. If you say $25,000 is the average settlement cost in other industries, that is about ten times higher than the standard settlement in the food industry. Even our legal fees are low, because of the extent to which we have refined our claims handling system." (Unlike most other industrial trade groups, the National Food Processors Association handles the liability claims of its members.)

"The only cost that consumers are really paying for," this executive continued, "is quality control." He said that the food industry's "phenomenal safety record" accounts for the "minuscule" loss record in claims handling.

Thus, while it may be true, as noted by a representative of the National Association of Insurance Brokers, that "Anytime a business or organization is faced with substantial new costs of doing business, these costs influence the price structure of goods and services," that influence is not significant with respect to expenses associated with product liability.[1] The major determinants of pricing in large companies remain what they have always been: shifting market tastes, technological innovations, the rise and fall of interest rates, domestic and foreign competition, labor and raw material costs, and so forth. Product liability does not constitute a major cost category, except in a small number of specialized firms such as football helmet manufacturers.

[1]*Congressional Record*, February 27, 1986, Vol. 132, No.2, p.S-1808.

Improved labels: The next most common management decision, taken by over a third of the firms, was to alter the labeling information on product use, making the instructions more explicit and warning against dangers associated with improper use.

Product design: The third most common decision, made by almost a third of firms, was to improve the safety design of the product. (Among the firms that improved their products' design, manufacturing process or labeling, a fifth reported a subsequent decline in product-related accidents.)

Discontinuation of products: One finding here deserves special attention. Almost a quarter of the firms have decided, within the past three years, either to discontinue manufacture of a product for the U.S. market, to rescind provision of a service, or to recall products already on the market, because of product-liability considerations. Theoretically, such decisions can have a considerable impact on the fortunes of the firms themselves and on the overall economy. Curtailment of production may mean foregone revenues, which, in turn, may precipitate layoffs and cause other negative ripples throughout the economy.

To test the theory, the questionnaire asked respondents to estimate how much money they lose annually—how much they forego in net revenues—through liability-related elimination of products or services to the U.S. market. Only one out of eight respondents answered the question, an even

Attorneys' Liability

Manufacturers and insurers are not the only ones on the receiving end of a significant increase in complaints, litigation and regulatory sanctions. Ironically, the legal profession itself—often cited as one of the principal culprits in the "product liability crisis"—is also the target of complaints, litigation and regulatory activity. In fact, statistics released by the American Bar Association show that, in the 35 states monitored by the ABA, complaints against lawyers rose by 38 percent during 1985. This increase, from 39,356 complaints to 54,152, is said by the ABA to reflect a growing inclination by the public and regulatory agencies to complain about and prosecute attorneys for a variety of missteps.

The number of cases varies widely among states. California leads the list with more than 5,000 cases currently pending, some of them more than a decade old, according to a recent article.[1]

The charges leveled against attorneys cover a broad range of professional misconduct, ranging from falsification of evidence to negligent and willful misrepresentation. One New Orleans sole practitioner was recently hit with a $1.5 million damage award because he urged a real estate client to appeal a case, asked the Louisiana First Circuit Court of Appeals for three extensions on this appeal, but negligently failed to file the appeal.[2] The number of disbarments of attorneys, as sanctions imposed by state courts, rose from 283 in 1981 to 459 in 1985, and the number of attorneys fined for misconduct from 381 in 1981 to 653 five years later.

Certainly, an increase in the number of attorneys contributes to a rise in the number of complaints and disbarments, since there are a greater number of possibilities for misconduct, given a larger population base. In California alone, there are close to 90,000 attorneys, and there is an average of one complaint against attorneys for every ten citizens in that state.

When manufacturers are hit with product-liability awards, one of the most frequent factors involved the producers' alleged failure to design a safe product. The same issue is behind the vast majority of legal malpractice cases, the ABA says. Its studies have shown that "general neglect" cases is the number one factor behind disciplinary actions, that is, fines or disbarments.

[1]Alberta I. Cook, "Complaints Rise Against Lawyers," *The National Law Journal*, October 27, 1986.

[2]Cabot and Forbes Company v. Brian, Simon, Peragine, Smith and Redfern, 80-20 60E.

smaller percentage than those who ceased production. Of the small remainder—41 corporations with $100 million or more in sales annually—under half estimate foregone revenues of less than $1 million a year, a third estimate losses between $1 and $5 million, and the rest, in decreasing percentages, forego higher amounts.

When placed within the context of the entire sample of 232 corporations, the above figures suggest, again, that product liability has a minor impact on this group of corporations. For the 25 percent of corporations that have been pressured by liability problems to eliminate products or services, or to recall products from the market, the amount of revenue most of them forego is very small in relation to their annual sales income.

It should follow that few employees are laid off as a consequence of product liability. And that, indeed, is what the survey shows. Of the quarter of respondents who ceased production or recalled products, 13 firms, or less than 6 percent of the total, laid off employees within the past three years for this reason. (See Chart 3.)

"Defensive Liability" Techniques

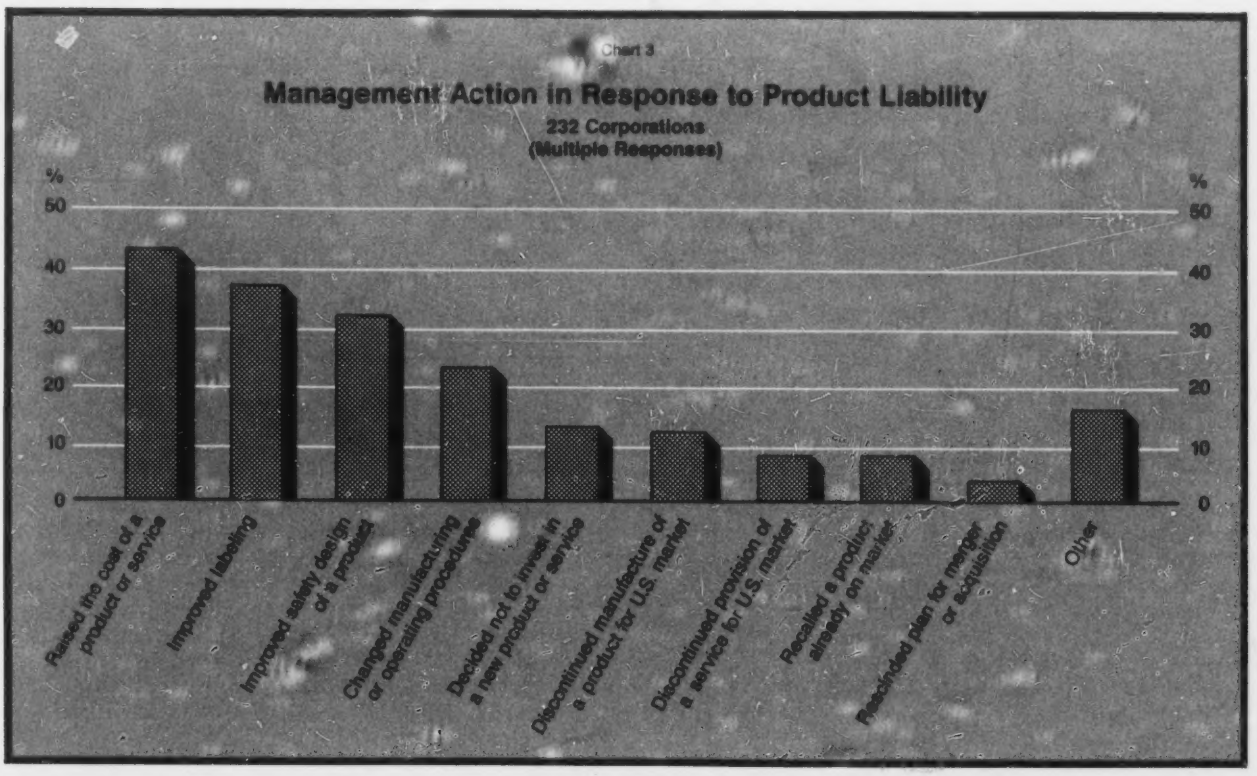
The spate of media attention given the liability and insurance crisis during 1986 would indicate that product liability is a major concern, and its reform a top political priority, for U.S. corporations. Survey findings present a mixed picture on this assumption. On the one hand, product liability remains only a part-time function for over three-quarters of the respondents. And in only one out of ten companies is the performance rating of a department head dependent, even in part, on product-liability claims brought against the firm. Both these findings suggest that the issue is not a central focus of most corporate decision makers in the conduct of their business.

On the other hand, at least two-thirds of the companies undertake one or more "defensive liability" practices, the two most common being to establish formal safety objectives and to monitor relevant court decisions. (See Chart 4 on page 16.) In addition, over half the companies are active to some degree in efforts to reform product-liability or insurance laws and regulations. For most of the active firms, this involvement takes the form of contributing to a business or industry lobbying group.

Reforms Sought by Corporations

A little over half of the risk managers volunteered information on the type of reforms they advocate. For most of these respondents, it is the tort system they wish to see changed. By contrast, only 6 percent recommend change in the insurance industry.

Tort Reform: The most frequently mentioned reforms sought by respondents in the area of tort law include estab-



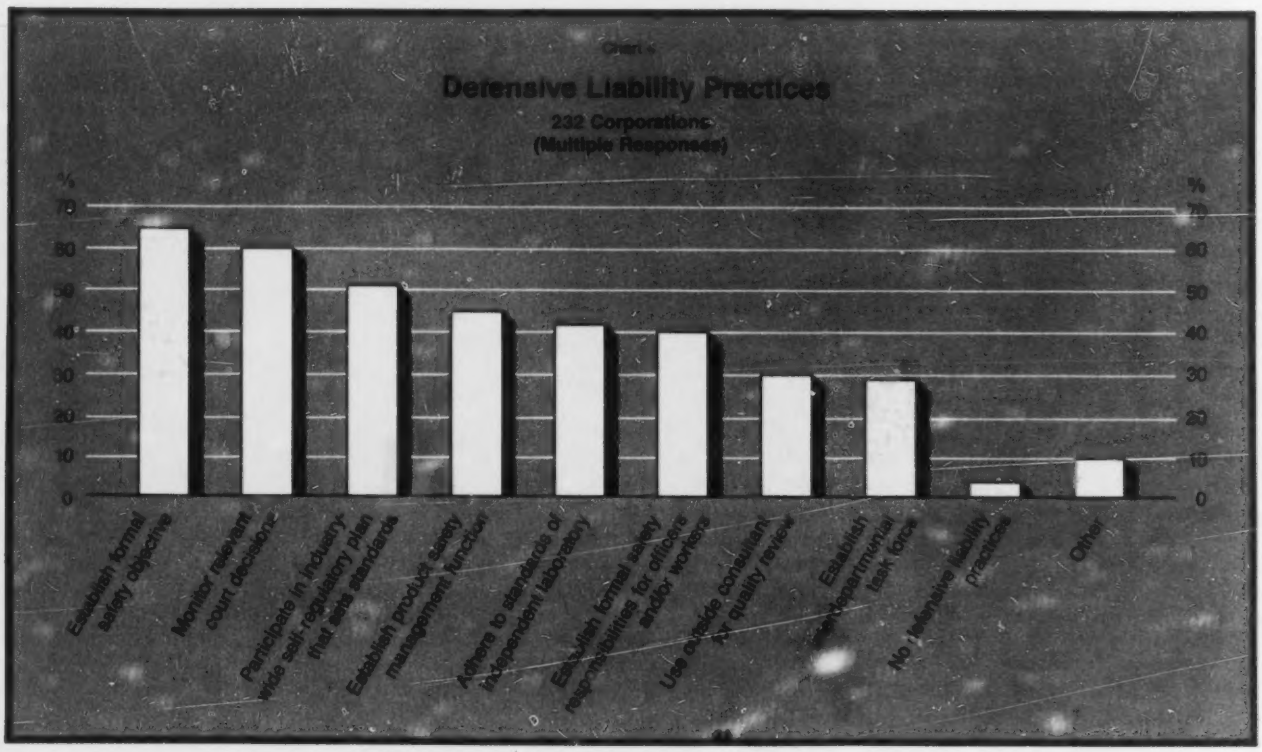
lishing a cap on court awards, rescinding the doctrine of "joint and several liability," and restricting, or eliminating, the use of contingency fees by plaintiffs' attorneys.

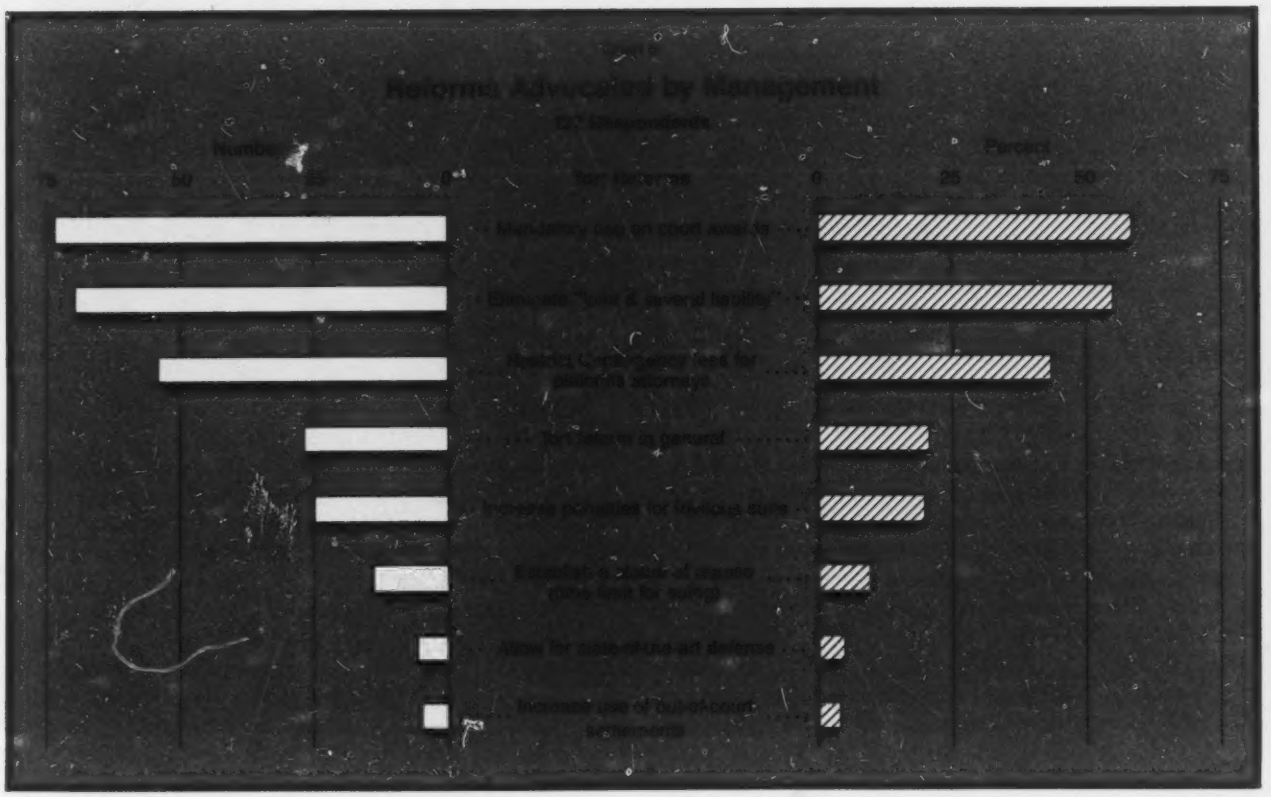
Advocating a cap on court awards may reflect management's concern with the reportedly growing number of multi-million-dollar judgments, particularly as a result of awards for pain and suffering and for punitive damages. According to the survey, however, most liability cases are settled out of court, and for relatively modest sums.

The desire to end the joint and several liability doctrine reflects management's discontent with being targets of a shotgun approach to liability lawsuits. As noted earlier, such an approach names as many defendants as possible in a suit, regardless of the amount of blame any one defendant may bear. Ultimately, the wealthiest defendant becomes the payer of last resort, irrespective of degree of blame. And while the number and amount of court awards has not been steep, at least to most respondents of this survey, the legal expense required to respond to charges is certainly unwanted.

Establishment of a cap on contingency fees—which would limit the percentage of a court award going to the plaintiff's attorney—might serve as a disincentive for lawyers to sue. Over 42 percent of the respondents seek this reform, and another 20 percent seek an end of what they call "frivolous" law suits. Together, almost two-thirds of the corporate respondents seek to limit sharply the number of suits filed against them. (See Chart 5.)

Insurance reform: Reforms of the insurance industry sought by 6 percent of the respondents include: stricter regulation of rates; easing the ability to establish and operate self-insuring (risk retention) mechanisms; and requiring insurance firms to compile and release more pertinent statistics. Several respondents also recommended improved product-safety requirements, which they felt would result in fewer lawsuits.




Reforms Advocated by Management
Number
Percent
75
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25
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Chapter 5
Legislative Activity

Partisans of reform of both the tort system and the insurance industry battled ferociously during 1986, both in the national and state arenas. While some federal insurance legislation was amended at this writing (November 1986), reforms—both major and minor—were passed or are likely to be passed in over 40 state legislatures, a reflection of the fierce lobbying efforts by organizations representing the insurance industry, corporate and association risk managers, trial lawyers, and consumer groups.[12] Many of those changes now face court challenges on state constitutional grounds.

State Legislation

Concerning tort or liability reform, many states imposed caps on noneconomic and punitive damage awards, limited or rescinded the doctrine of joint and several liability as applied to punitive damages, and allowed court awards to be paid out in installments—so-called structured payments—rather than in a single lump sum. Some states also reduced court awards by the amount of compensation a plaintiff receives from "collateral sources"—workers compensation, social security payments, and so forth. Predictably, these reforms were hailed by the insurance industry and corporate spokespeople, and condemned by consumer advocates and trial attorneys.

In the area of insurance, one of the most common reforms was the authorization of—or requirement for—joint underwriting associations (JUA's), a process by which all commercial insurance companies in a state take on the liability risks that no one insurer wishes to assume. JUA's constitute, in effect, an alternative market. In some states, such as in Minnesota, the insurance commissioner was given increased leeway to provide state government coverage for a limited period of time. The state of Florida enacted some of the most far reaching changes, mandating a rollback of insurance rates up to 40 percent for 90 days, with a further rollback to 1984 levels unless insurance companies can demonstrate that those levels are unjustified. In protest, several major insurance firms announced a cessation of new liability policies in Florida. In response, the president of the Florida Senate warned that he would seek legislation barring any insurer who withdraws from the state from reentry for the next ten years, with coverage to be provided by newly formed joint underwriting associations.[13] The intensity of the battle in Florida—still heated as of this writing—serves as a barometer for the rest of the nation. In New York, for instance, the state commissioner publicly requested insurers to lower their rates by up to 20%, to compensate for the savings they can expect from state tort reforms.[14]

[12]For a description of state-by-state reforms, see *Resolving the Liability Crisis: State Legislative Activities in 1986*, Denver: National Conference of State Legislatures.

[13]Peter Van Aartrijk, "E & S Carriers Pick Up Slack in Florida Market," *National Underwriter*, July 25, 1986.

[14]David Katz, "N.Y., Citing 20 Percent Savings, Asks Cuts to Match Tort Reforms," *National Underwriter*, September 19, 1986, p.6.

Tort Reform and Insurance Rates

The relationship between tort reform and insurance rates is at the heart of the liability issue. Insurers maintain that rates are high in large part to compensate for overly generous court awards granted in an unpredictable fashion. Consumer groups argue that tort reforms have no direct or indirect bearing on insurance rates. Following tort reforms enacted in Florida in 1986, Aetna Casualty and Surety Company filed rates with the Florida Insurance Commissioner. According to its filing papers, Aetna indicated that the reforms will have no impact on its costs, and therefore its rates would not decline. (In fact, the insurance company requested an increase in rates, for other reasons.) Aetna's filing in Florida therefore confirmed the absence of a relationship, according to consumers. However, in New York State, Aetna's filing called for a 7 percent decline in rates, owing to the New York tort reforms. According to the Aetna actuary who prepared the filings, the New York case clearly demonstrates a relationship between tort reforms and insurance rates.

Federal Legislation

Product Liability and Tort Reform

On the federal level, the Uniform Product Liability Act (S.2760) was reported out of the Senate Commerce Committee at the end of June, 1986. While it did not pass the entire Senate, the action of the Commerce Committee raised speculation that almost a decade of efforts by the insurance industry and risk managers to secure national tort liability reform would soon reach fruition, perhaps as early as the next session. Introduced by Senator John Danforth (R-Mo), the bill contained most of the elements advocated by corporate risk managers and insurers. Major provisions included:

Expedited settlement procedures: Either party to a dispute can seek to settle the claim quickly, by accepting the following terms: Payment to the claimant of a court-determined economic loss (loss of wages, medical expense, and so forth); plus payment of $100,000 for "dignitary loss." The economic loss is to be paid in installments rather than in a lump sum. The dignitary loss, a substitute for the existing category of "pain and suffering," is intended as compensation for death of a family member, permanent disfigurement, loss of an organ or limb, and so on.

If the defendant rejects the terms, and then loses in court for an amount equal to or greater than those terms, the defendant has to pay the claimant's legal fees, up to $100,000. If the claimant rejects the offer, he or she may only collect a limited amount, set by formula, for both economic loss and punitive damages.

Sellers' liability: Sellers of defective products, such as retailers, dealers and the like, would be liable, in most cases, only if their own lack of reasonable care in handling the items was the proximate cause of the injury. In effect, this provision severely modifies the doctrine of joint and several liability.

Multiple defendants: In cases involving more than one defendant, each defendant's liability for noneconomic charges would be limited to that defendant's degree of responsibility for the injury, as determined by the court. This provision would further erode the notion of joint and several liability.

Punitive damages: Punitive damages could be awarded only where it is proven that an injury was the result of "conscious, flagrant indifference" on the part of the manufacturer to the user of a product. Furthermore, no punitive damage at all could be imposed in cases involving over-the-counter drugs, aircraft, or medical devices that have been approved for marketing by a federal agency.

Other provisions included:

- A two-year time limit for the filing of complaints, starting from the time a claimant discovers—or "should have discovered"—the injury and the possible cause;
- A definable statute of repose, in this case a 25-year time limit in which any complaint can be brought, with the exception of claims against toxic substances. For items not considered "capital goods," the statutory time limit is ten years;
- Awards granted in a liability case to be offset by any benefits the claimant obtains under the federal workers compensation law;
- A disclosure provision, requiring insurance companies to report to the Secretary of Commerce annual data showing the impact of this law on their business operations. The purpose of this provision is to test whether the absence of tort reforms is the cause of insurance price increases and availability declines, as the insurance industry alleges. Disclosure had been urged by Senator Paul Simon (D-Il) who argued that Congress finds "great difficulty" in securing adequate statistical information about the industry on which to base regulatory policy.[15]
- A provision to make it more difficult to sue U.S. firms in U.S. courts for accidents occurring abroad. European courts are said to be more lenient toward manufacturers in liability cases. However, this may change in light of a new statute passed in 1985 by the Common Market. (See box, page 20, column one.)

Some 200 product liability bills were introduced in the House in 1986, but none was reported out of committee. Judiciary Subcommittee Chairman Peter W. Rodino (D-NJ), in a statement released on June 9, 1986, indicated the reasons for his reluctance to accept insurance industry allegations that they are financially ailing due to the tort system: "For product liability, including both bodily injury and property damage, of the premium dollars taken in over the past ten years, less than half have been paid out for claims and allocated adjustment expenses—the companies have paid out just $1.7 billion on a premium volume of $4.3 billion. That's a positive cash flow of $2.6 billion, not including investment income." The statement added that these figures were derived from information provided by the Insurance Services Office.

One of the bills presented to Congress was submitted by the Reagan Administration at the end of April 1986. That bill would have limited noneconomic awards to a total of $100,000 for all claims arising out of a single injury or death; would have sharply curtailed contingency fees; and would have released manufacturers from liability in design defect (the most common allegation in liability lawsuits) and failure-to-warn cases, unless it can be proved that the ability to eliminate the defect was technologically "reasonably feasible" at the time the product was manufactured.[16]

[15] "Senate Judiciary Panel Members Press Justice Department Official on Insurance Data," *Daily Executive Report*, September 10, 1986, p.A-9.

[16] "White House Sends Congress Three Draft Bills to Improve Tort Reform Situation," *Daily Executive Report*, May 1, 1986, p.A-13.

Risk Retention

The Product Liability Risk Retention Act of 1986 (PL 99-563), signed by the President on October 27, amends a five year old law by expanding the right of small business and other groups to obtain liability insurance in an alternative market. Essentially, the Risk Retention Act allows corporations and others to insure themselves if they cannot or choose not to purchase insurance on the regular market. Self insurance is obtained through the establishment of a "risk retention" group that writes policies and accepts payments at rates set by the members. The law overrides any state law that prohibits the establishment of either risk retention or insurance purchasing associations.

The amended act eliminates obstacles faced by numerous trade and professional groups to establish captives, allows risk retention groups to expand the types of insurance they may provide from product to general liability insurance, and authorizes state commissioners to halt a group's operation if the commissioner believes it to be in "hazardous financial condition." The amendments also require the Secretary of Commerce to report on how the Act helps to resolve "problems relating to the unavailability and unaffordability of liability insurance."

Because risk retention groups compete directly with existing private insurance companies, the latter have strenuously opposed both the law itself and any efforts to expand its applicability or the type of insurance it covers. State commissioners, in turn, have pushed for increased state regulation of the groups, warning that the absence of state oversight leaves consumers unprotected in the event of a group's insolvency. On the other hand, corporate risk managers support the Act, which provides them with access to another market, and often ally themselves with other groups seeking to self-insure (for example, midwives). Insurance brokers, who would be able to sell policies for the risk retention groups, also support the Act.

Product Liability In Europe

U.S. corporations exporting to any part of the European Economic Community (the Common Market) may be subject to a more stringent product liability doctrine by July 31, 1988 at the latest. On that date, each member state will likely adhere to a new EEC statute passed in 1985 to unify the varying laws of the member states on consumer protection.[1] Most likely to be affected are the drug, chemical, food, tobacco, automotive and aerospace industries. The new statute—already adopted by some states—mandates the application of strict liability, which essentially means that the seller of a defective product is liable for any injury caused by its use. This doctrine, of course, has long been in effect in the United States, having been refined largely through case law during the 1960s and 1970s.

The EEC law, which pertains to components as well as finished products, has been hailed by consumers, who no longer have to sustain the burden of proof that the manufacturer had failed to exercise proper care in the manufacturing process. Business groups in general opposed the law, arguing that it would lead to unacceptably high insurance costs. One provision, however, is supported by business and opposed by consumers: The law specifically excludes "development risks" from manufacturers liability. Development risks pertain to defects that could not be discovered in light of technical and scientific knowledge available at the time the product was put on the market. (In the United States, this is known as a state-of-the-art defense.) Of particular importance to U.S. firms is that the manufacturer's liability can no longer be limited or excluded by clauses to that effect in sales contracts. Such clauses are still allowed under the laws of most individual EEC states, but will have to end completely by July 31, 1988.

[1]Council Directive 85/374/EEC. For a commentary on the EEC law, see "Common Market Reports," Commerce Clearing House, 538, October 24, 1985, P.11,706.

ACCA on Liability Issues

Following are the positions taken by the American Corporate Counsel Association on tort liability:

Tort System: Due to the continued rapid expansion of product liability litigation, continued inconsistencies in tort law and interpretation among and within the states, and subsequent erosion of liability insurance, tort reform is vital at both the federal and state levels.

Damage Awards: Make the public aware of the cost to all of the ever-expanding sizes of damage awards for injuries, the multiplication of unjustified theories of recovery, and the spiralling costs of litigation. Limit or eliminate punitive damages.

Investigations: Limit discovery abuse (pretrial investigation of the facts.)

Legal Access and Contingency Fees: Diligently explore methods to administer claims efficiently and to deliver quality legal services to parties in civil cases at reasonable cost. Control the use and amount of contingent fees contracts to appropriate limits.

Resolution of Cases: Pursue and encourage the use of Alternative Dispute Resolution techniques as appropriate.

Joint and Several Liability: Limit or eliminate joint and several liability.

Collateral Source: Eliminate the collateral source rule allowing inappropriate double recovery of damages and allow full disclosure of all facts bearing on a plaintiff's financial loss.

Strict Liability: Develop a fair and reasonable standard of liability and proof of causation for cases involving the toxicity of chemicals, including a reasonable state-of-the-art defense.

Antitrust Immunity

A bill to amend the McCarran-Ferguson Act, which has been shielding insurance companies from the reach of most federal antitrust laws since 1945, was introduced by Senator Simon in 1986, but is not considered likely to be acted on soon. Most insurance industry representatives oppose any weakening of the Act, which allows for collective rate setting and other activities prohibited in other industries. McCarran-Ferguson also provides that the regulation of insurance is fundamentally a state rather than a federal matter.

Repeal or "sunsetting" of the Act is urged primarily by consumer advocates, but for the past several years a number of insurance representatives have also argued that the Act has outlived its usefulness. By repealing the Act, they maintain, insurance companies would be released from state regulation, which they assert has become unnecessary given the competitive structure of the industry.[17]

[17]For a review of the historical setting of the McCarran-Ferguson Act and a discussion on the merits of state versus federal regulation, see Nathan Weber, *Insurance Deregulation: Issues and Perspectives*, Conference Board Report No. 824, 1982.

Conclusion

The uproar over the tort liability system and the policies of the insurance industry that filled the pages of the nation's popular and business press during 1986 seem, upon analysis, to reflect more the political muscle of competing groups in society than any actual or impending disaster. At least for major corporations, the so-called twin crises of liability and insurance have had relatively little impact. Since 1982, product-liability coverage has remained steady in most cases, although its cost has risen substantially. While the actual number of lawsuits faced by corporations is high, most tort claims are settled out of court, for relatively modest sums.

Management does pass on the cost of the insurance, and perhaps legal expenses, in consumer prices, but the total amount of the increase for most firms is small. While exerting some negative impact on corporations and on society, product liability has also motivated management to positive actions: for example, improving product safety, product use and warning labels, and manufacturing quality. Nevertheless, legislators in over 40 states have been moved by the uproar to pass, or deliberate on, tort and insurance reform laws. On the federal level, significant tort reform may be nearing enactment after a decade of efforts by the insurance industry and risk managers. It is not inconceivable that these legislative reforms will have more of an impact on corporate behavior, and on consumers, than the supposed crises that gave rise to them.

ATLA on Liability Issues

Following are excerpts from position papers prepared by the Association of Trial Lawyers of America.

Tort System: Imperfect though it may be, the system today serves two vital functions: it deters negligence and it fairly compensates victims. The system helps to eliminate wrongs; the so-called reformers want to eliminate rights. As [a Yale professor] said, "Law reform really gets going when the plaintiffs start winning."

Caps on Awards: Caps punish only the worst afflicted—those who are catastrophically injured by the carelessness or unfitness of others. Caps punish those whose quality of life has been destroyed, those who will never be able to work again. Besides, who is fit to put a price tag on a lifetime of pain and suffering; to set up the marketplace where pain is bartered?

Strict Liability: This doctrine holds a manufacturer liable for harm that results from a defective product. No defect, no liability. Reformers would replace this doctrine with a standard that in many cases would require proof of manufacturer negligence. Injured consumers would have to prove not only that a product was defective and caused the injury—no easy task. They would also have to scale nearly insurmountable barriers to recovery, because the negligence standard would require gathering evidence of the manufacturer's state of mind from perhaps the sole and recalcitrant possessor of that evidence—the manufacturer.

Collateral Source: The collateral source rule holds that a wrongdoer should not profit if a plaintiff is protected by insurance that in many cases the plaintiff pays for personally. Why give wrongdoers and their insurance carriers a windfall when the injured victim has paid premiums directly or indirectly to the collateral source?

Structured Settlements: Such settlements may be an excellent device in some cases. But that choice should be left to the plaintiff. Mandating structured settlements permits insurers to continue to earn income on the unpaid portion of the award, instead of giving the victim the chance to earn that income.

Joint and Several Liability: Abolishing this doctrine would not cut insurance rates. It would mean less compensation for innocent victims, higher taxes to pay for assistance programs for those victims, and increased profits for the insurance industry.

Contingency Fees: Limits on such fees discriminate against plaintiffs who can afford only lawyers who are willing to take cases on a contingent basis. There is no limit on the fees of defense lawyers. There is no limit on what a wealthy client can pay a lawyer.

Frivolous Suits: Common sense shows that a lawyer working on a contingent basis is most unlikely to bring such a suit. It's almost a sure loser, and one-third of nothing is nothing.

Related Readings from The Conference Board

Melissa A. Berman (ed.), *Corporate Culture and Change,* Report No. 888, 1986.

Jeremy Bacon, *Liability Insurance for Directors,* Perspectives No. 1, 1986.

Nathan Weber (ed.), *Insurance Deregulation: Issues and Perspectives,* Report No. 824, 1982.

Patrick J. Davey, *Managing Risks Through Captive Insurance Companies,* Report No. 768, 1982.

E. Patrick McGuire, *The Product Safety Function: Organization and Operations,* Report No. 754, 1979.